



Seðlabanki Íslands

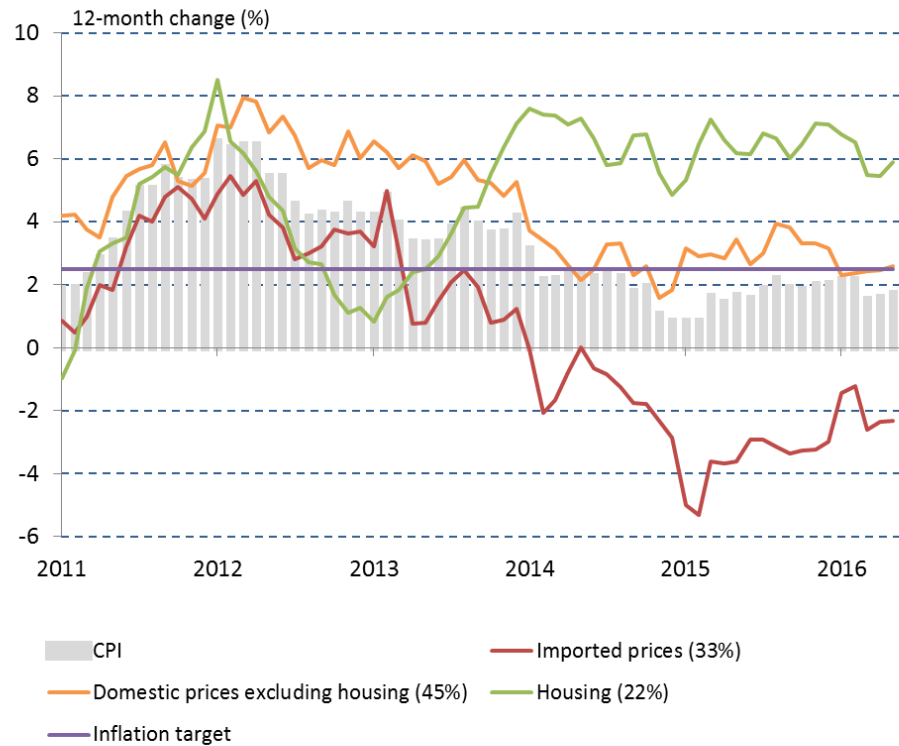
Monetary policy challenges

Meeting of the Macroeconomic Council

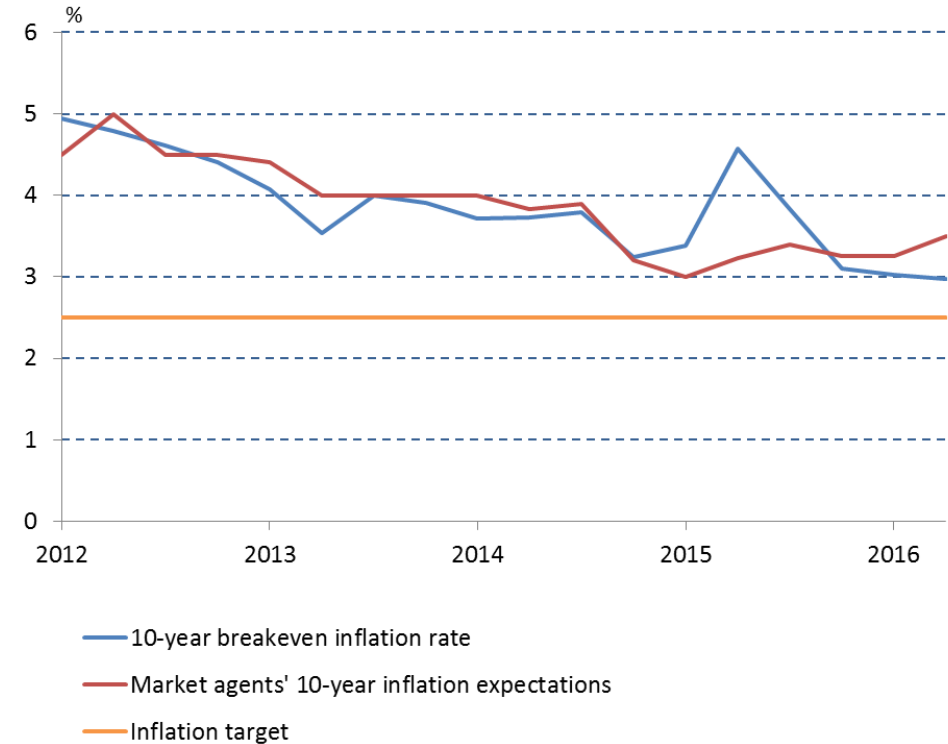
8 June 2016

Inflation below target for over two years, and inflation expectations have fallen in recent years

Imported and domestic inflation¹
January 2011 - May 2016



Long-term inflation expectations²
Q1/2012 - Q2/2016



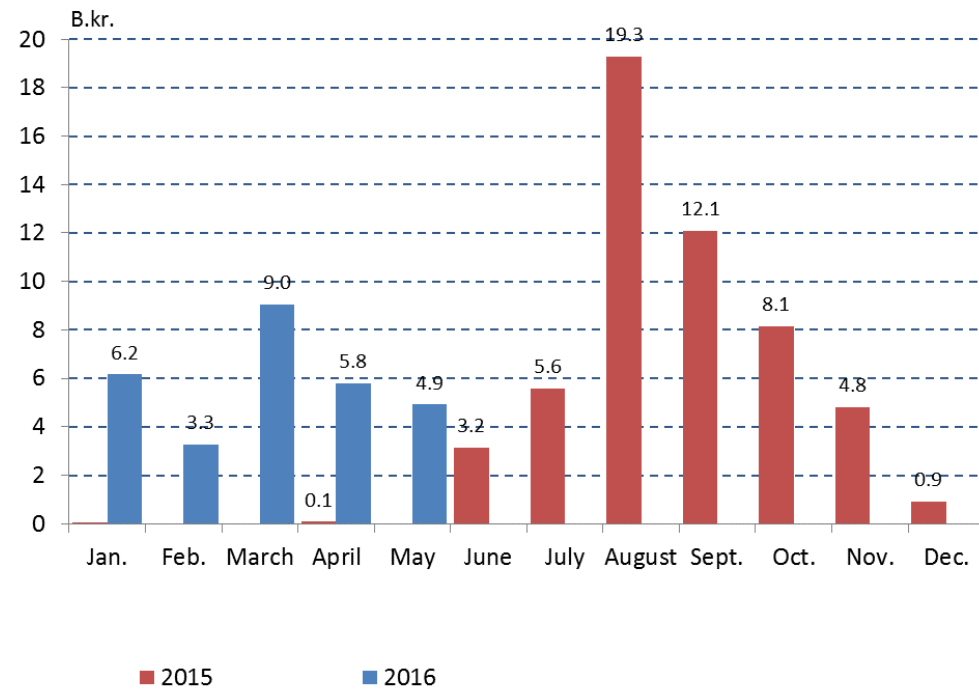
1. Imported inflation is estimated using imported food and beverages and the price of new motor vehicles and spare parts, petrol, and other imported goods. Domestic inflation is estimated using the price of domestic goods and the price of private and public services. The figures in parentheses show the current weight of these items in the CPI. 2. The figure for the 10-year breakeven inflation rate in Q2/2016 is the Q2 average to date.

Sources: Statistics Iceland, Central Bank of Iceland.

Capital inflows to the Treasury bond market have disturbed the monetary policy transmission mechanism

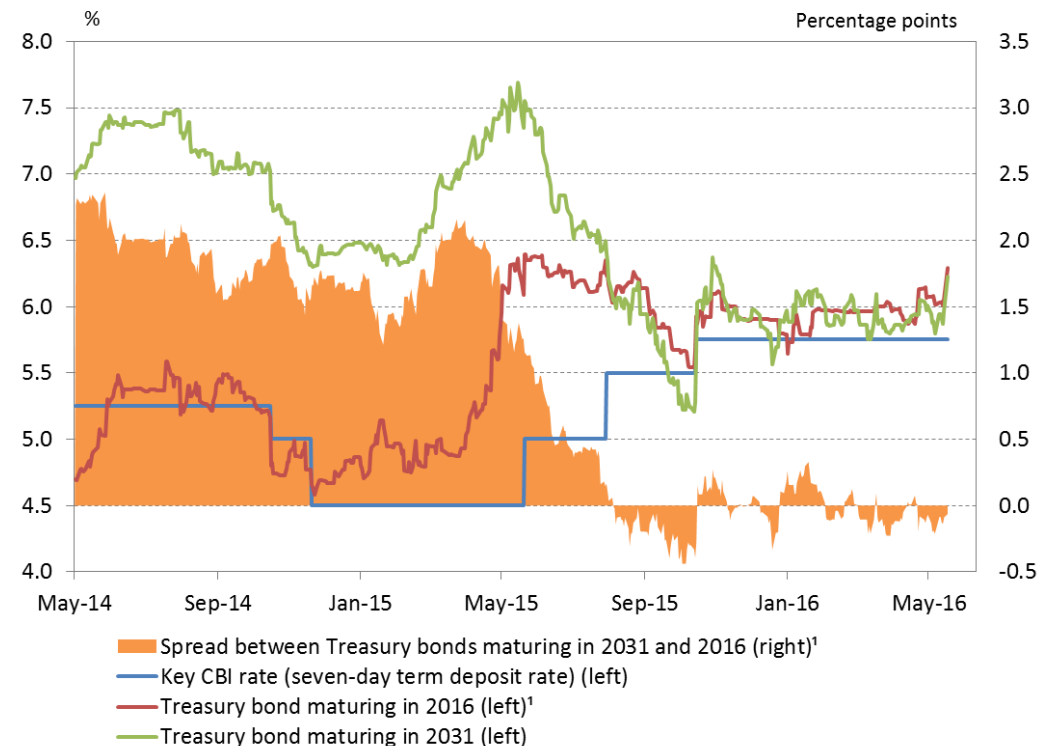


Reported new investments in Treasury bonds
January 2015 - May 2016



Source: Central Bank of Iceland Capital Controls Surveillance Unit.

Key Central Bank rate and nominal Treasury bond yields
Daily data 21 May 2014 - 6 June 2016

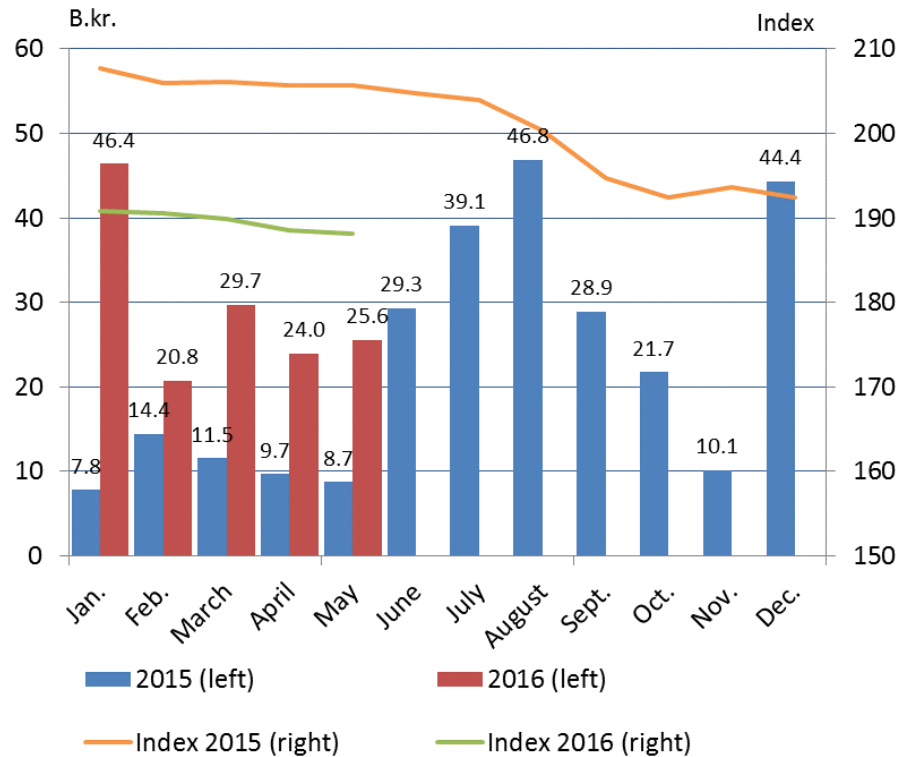


1. From 14 April 2016, Treasury bond maturing in 2017 instead of 2016.
Source: Central Bank of Iceland.

Exchange rate and foreign currency purchases

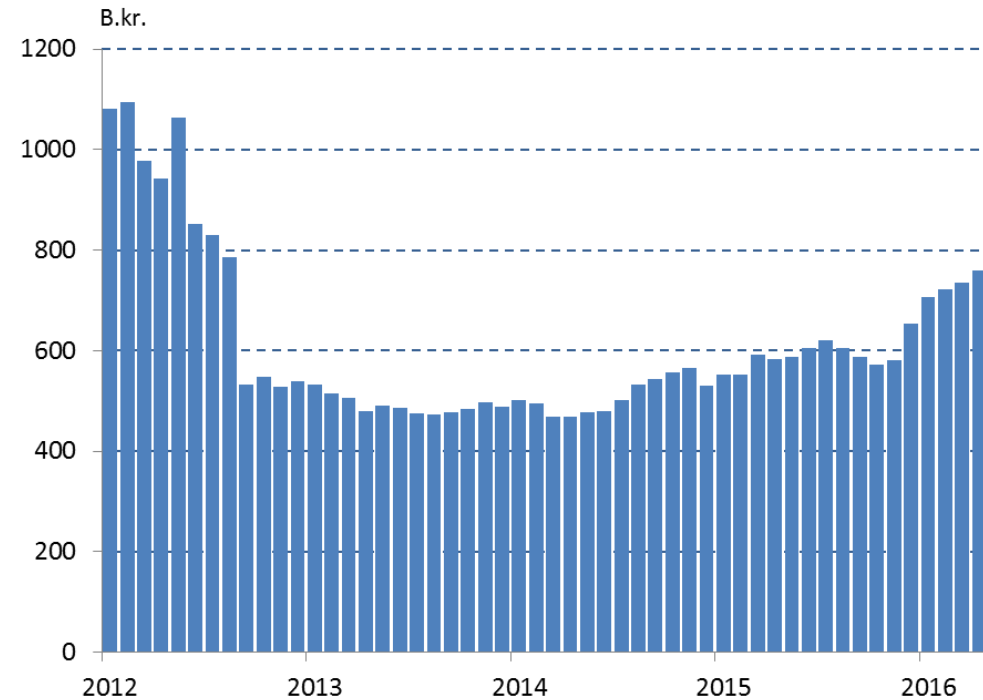


Central Bank foreign currency purchases in the interbank market
January 2015 - May 2016



Source: Central Bank of Iceland.

Central Bank foreign exchange reserves
January 2012 - April 2016



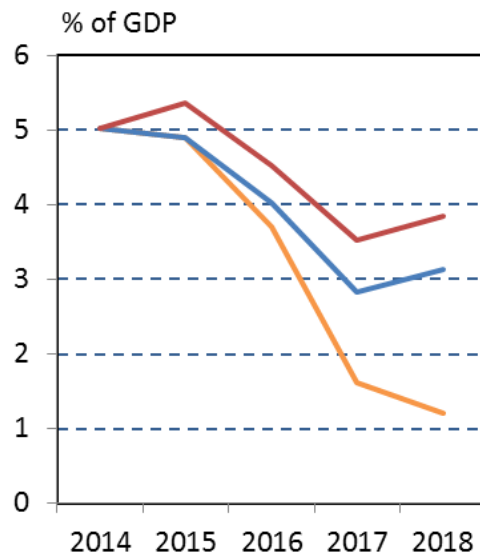
Source: Central Bank of Iceland.

Tighter fiscal policy would help

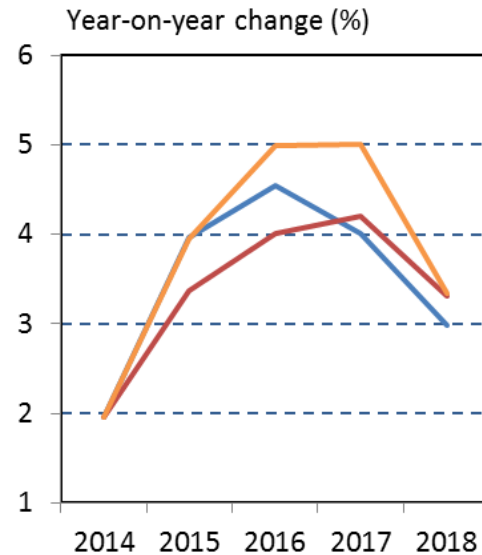
- Tighter fiscal policy: neutral policy in 2015-16 instead of increased slack in both years: greater slack has added about ½ a percentage point to GDP growth in each year, increased inflationary pressures, and reduced the current account surplus ... with interest rates 0.5 points higher in 2016 and 0.75 points higher in 2017
- The ratio of private consumption to GDP rises more rapidly: GDP growth about ½ a point more in 2016 and 1 point more in 2017: current account surplus disappears faster and inflationary pressures will be greater ... interest rates 0.75 points higher in 2017 and nearly 1.5 points higher in 2018

Alternative scenarios

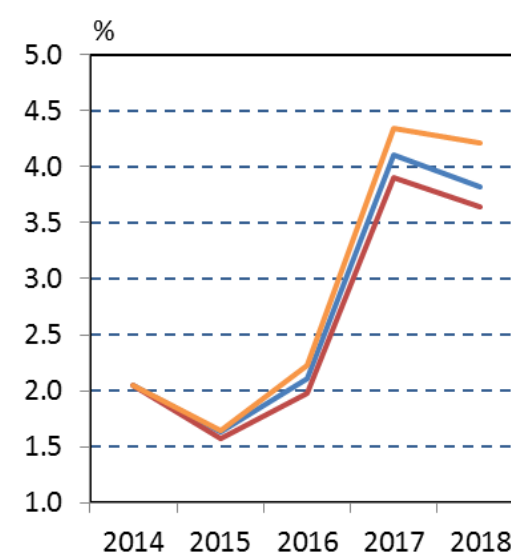
Current account balance



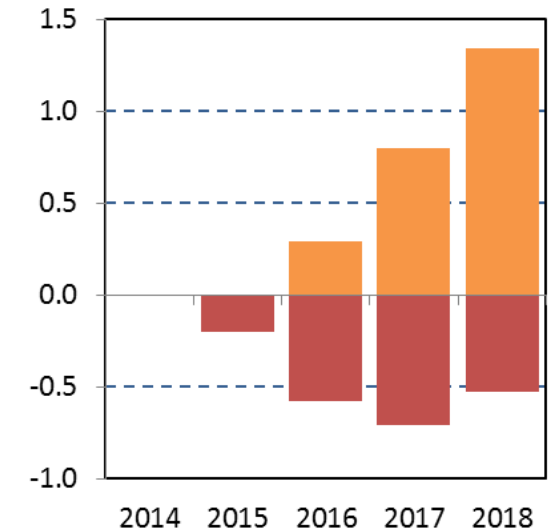
GDP growth



Inflation



Central Bank interest rate
Difference between annual averages
(percentage points)



— Baseline forecast, MB 2016/2

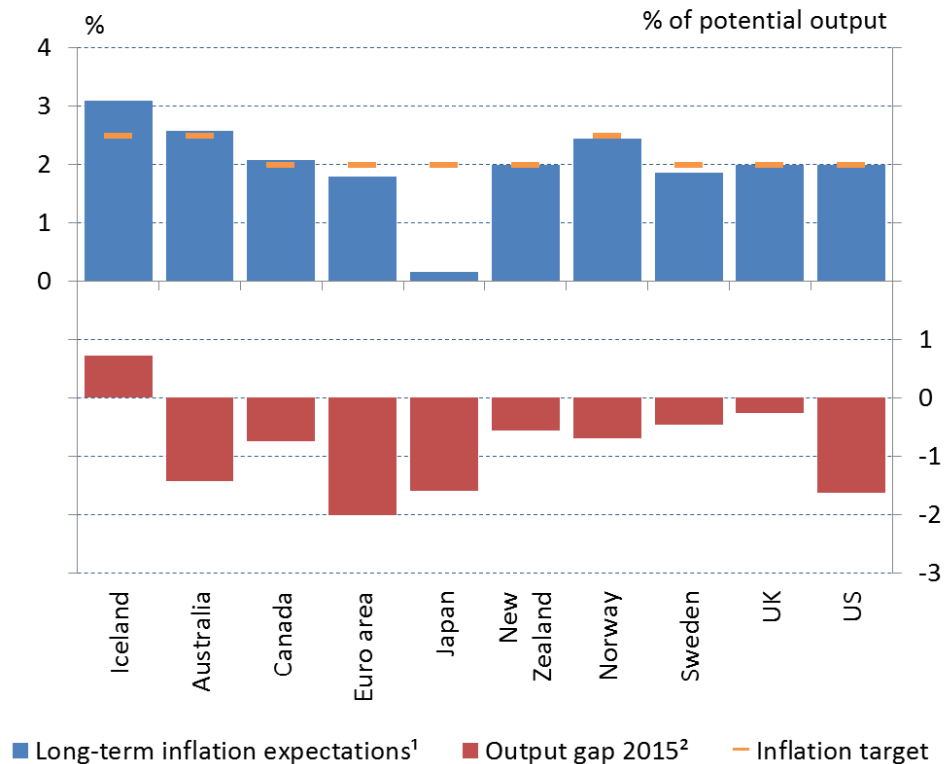
— Tighter fiscal policy

— More rapid growth in private consumption

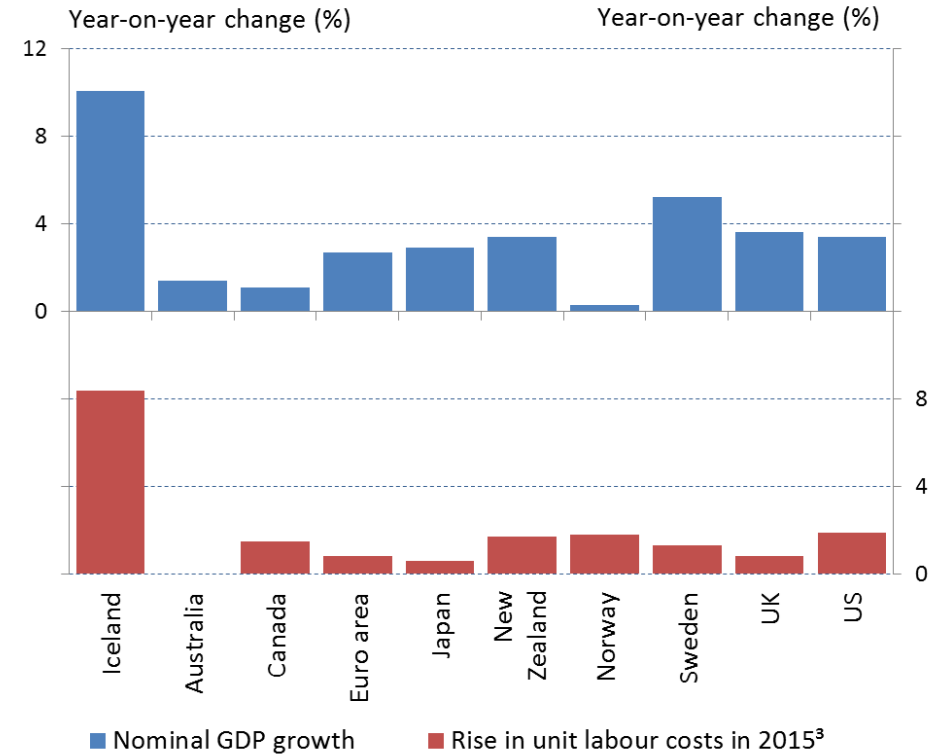
Why are interest rates higher in Iceland?

- Even though observed inflation in Iceland is similar to that in other industrialised countries, interest rates are somewhat higher ... why?
- Inflation expectations have been persistently above target here but at or below target in other industrialised countries
- In Iceland, a positive output gap has opened up, whereas there is still a slack in other industrialised countries (and the difference will increase this year)
- Growth in nominal demand and wage costs is also much stronger in Iceland than in other industrialised countries

Inflation expectations and output gap in selected industrialised countries



Nominal GDP and wage costs in selected industrialised countries



1. Market agents' four- to five-year inflation expectations (based on IMF forecast four years ahead for UK and Canada and five-year inflation swap agreements five years ahead for Japan and Australia). 2. Central Bank estimate for Iceland ; IMF estimate for other countries. 3. Figures for Iceland are based on estimates in Monetary Bulletin 2016/2.

Sources: Bloomberg, International Monetary Fund, OECD, Statistics Iceland, websites of the relevant central banks, Central Bank of Iceland.